

**Improved Documentation Is Needed to Ensure
Taxpayers Are Informed of Their Rights When
Requested to Extend the Assessment Statute**

September 2002

Reference Number: 2002-40-175

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 24, 2002

MEMORANDUM FOR COMMISSIONER ROSSOTTI

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Acting Inspector General

SUBJECT: Final Audit Report - Improved Documentation Is Needed to
Ensure Taxpayers Are Informed of Their Rights When
Requested to Extend the Assessment Statute
(Audit # 200240006)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) is complying with Internal Revenue Code (I.R.C.) Section (§) 6501(c)(4)(B) requiring the IRS to provide notice to taxpayers of their rights to refuse to extend the assessment statute of limitations or to request that any extension be limited to a specific period of time or to specific audit issues.¹

The Treasury Inspector General for Tax Administration (TIGTA) is required to provide information annually regarding the IRS' compliance with I.R.C. § 6501(c)(4)(B).² The IRS is required to advise taxpayers of their rights whenever requesting an extension of the statute of limitations on assessment of additional tax and penalties. In passing this law, the Congress expressed concern that taxpayers were not being adequately advised of their rights to refuse to extend the statute of limitations or to request that a statute extension be limited to a specific period of time or to specific issues.

In summary, employees properly advised taxpayers of their rights to refuse or restrict the scope of the statute extension in 32 of 48 (67 percent) of the tax returns sampled. However, in 16 of 48 (33 percent) of the tax returns sampled, we could not determine if employees advised taxpayers of their rights because related case files did not contain a record that taxpayers had been advised of their rights. In 22 of the 24 (92 percent) jointly filed returns sampled, there was no documentation in the related case files that each taxpayer listed on the return was separately informed of his or her rights (i.e., dual

¹ I.R.C. § 6501(c)(4)(B) (Supp. IV 1998).

² I.R.C. § 7803(d)(1)(C) (Supp. IV 1998).

notification). Additionally, in 24 of the 33 tax returns sampled (73 percent) where taxpayers made a declaration of representation, there was no documentation in the related case files that the IRS had provided both the taxpayers and the representatives with the advice of rights.

Management's Response: IRS management responded favorably and agreed with the information included in our report. Specifically, they stated that they are pleased our review found that they are addressing the issues relating to I.R.C. § 6501(c)(4)(B).

Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers who are affected by the report. Please contact me at (202) 622-6510 if you have questions or Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

**Improved Documentation Is Needed to Ensure Taxpayers Are Informed of Their Rights
When Requested to Extend the Assessment Statute**

Table of Contents

Background	Page 1
Most Related Case Files Documented That Taxpayers or Their Representatives Were Advised of Their Rights Regarding Assessment Statute Extensions.....	Page 3
Compliance With Dual Notification Requirements Needs Improvement	Page 6
Compliance With Procedural Regulations Needs Improvement	Page 7
Appendix I – Detailed Objective, Scope, and Methodology	Page 8
Appendix II – Major Contributors to This Report.....	Page 10
Appendix III – Report Distribution List	Page 11
Appendix IV – Outcome Measures	Page 12
Appendix V – Management’s Response to the Draft Report	Page 13

Improved Documentation Is Needed to Ensure Taxpayers Are Informed of Their Rights When Requested to Extend the Assessment Statute

Background

The Internal Revenue Service (IRS) is required by Internal Revenue Code (I.R.C.) Section (§) 6501¹ to advise taxpayers of their rights whenever requesting an extension of the statute of limitations on assessment of additional tax and penalties. In passing this law, the Congress expressed concern that taxpayers were not being adequately advised of their rights to refuse to extend the statute of limitations or to request that a statute extension be limited to a specific period of time or to specific issues.

If the IRS audits a tax return and determines there is an additional tax liability, it generally must be assessed within 3 years from the date that a return was due or the date that the return was actually filed, whichever is later. This 3-year assessment statute of limitations normally cannot be extended without the taxpayer's written agreement.² To extend the assessment statute, the IRS asks the taxpayer to sign a statute extension agreement form (consent).³

A consent extends the assessment statute of limitations to either a specific period of time or for an unlimited, indefinite period. The statute is usually extended for a period that both the IRS and the taxpayer agree is reasonable to complete the audit. The consent can also be negotiated to apply only to certain audit issues.

A taxpayer might agree to extend the assessment statute of limitations for the following reasons:

- The taxpayer may want to pursue additional audit issues that are in the taxpayer's favor in offsetting a proposed tax or that might allow for a tax refund.
- If the remaining time before the statute expires is too short, the IRS may have to prematurely stop the audit process and issue a notice of deficiency that limits the

¹ I.R.C. § 6501(c)(4)(B) (Supp. IV 1998).

² There are some exceptions to the 3-year statute of limitations. For example, I.R.C. § 6501(c)(1) (1994) extends the assessment statute indefinitely when false or fraudulent returns are filed.

³ IRS employees who most often request assessment statute extensions are examiners in the Examination function of the operating divisions and appeals officers in the Office of Appeals.

Improved Documentation Is Needed to Ensure Taxpayers Are Informed of Their Rights When Requested to Extend the Assessment Statute

time for the normal appeals process before the taxpayer must file a petition to the United States Tax Court.

There are also certain circumstances when a taxpayer may decide to limit or refuse to extend the assessment statute of limitations.

- The taxpayer may not want to provide the IRS additional time to consider additional audit issues.
- The taxpayer may not want to allow the IRS the opportunity to further develop audit issues already under consideration after the normal statute period has expired.

In addition, the IRS Restructuring and Reform Act of 1998 (RRA 98) § 3201 requires the IRS to send any notice relating to a jointly filed return separately to each individual filing the joint return.⁴ Federal regulations require that any notice or other written communication (or copy) required or permitted to be given to a taxpayer in any matter before the IRS must also be given to the taxpayer and, unless restricted by the taxpayer, to the taxpayer's representative.⁵

The Treasury Inspector General for Tax Administration (TIGTA) is required to provide information annually regarding the IRS' compliance with I.R.C. § 6501(c)(4)(B).⁶ This report presents the results of the TIGTA's third annual review of the IRS' compliance with the statute extension provisions of the law. In the prior two reviews, the TIGTA evaluated the IRS' assessment statute extensions processed from January 1 to March 24, 2000, and April 1 to September 30, 2000, respectively.⁷ We reported that in the majority of the related case files reviewed, IRS employees

⁴ Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

⁵ 26 C.F.R. § 601.506 (2001).

⁶ I.R.C. § 7803(d)(1)(C) (Supp. IV 1998).

⁷ *Information Provided to Taxpayers When Requesting Extensions of the Assessment Statute of Limitations Can Be Improved* (Reference Number 2000-10-142, dated September 2000); *Most Taxpayers Are Advised of Their Rights Before Signing an Agreement to Extend the Assessment Statute of Limitations* (Reference Number 2001-10-157, dated September 2001).

Improved Documentation Is Needed to Ensure Taxpayers Are Informed of Their Rights When Requested to Extend the Assessment Statute

advised taxpayers of their rights to refuse or restrict the scope of the statute extension (95 and 94 percent, respectively).

For this year's audit, we reviewed assessment statute extensions recorded on taxpayer accounts from October 1, 2000, to September 30, 2001. The results of this review should not be compared with those of the prior reviews since the sampling methodology used this year is not consistent with those used in the prior years. This review was performed in the Small Business/Self-Employed Division Headquarters and the Office of Appeals Headquarters.

We performed the audit between March and July 2002 in accordance with *Government Auditing Standards*. Detailed information on the audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

In 32 of the 48⁸ tax returns sampled (67 percent), IRS employees advised taxpayers or their representatives of their rights to refuse or restrict the scope of the statute extension. We considered that IRS employees advised taxpayers of their rights if any of the following documentation was found in the related case files:

- A copy of Letter 907 (L-907) or Letter 967 (L-967), "Request to Extend Statute of Limitation Period" or comparable cover letter, updated to include an explanation of taxpayer rights.
- A record that *Extending the Tax Assessment Period* (Publication 1035) was provided to the taxpayer and/or representative, as documented in the audit contact record or as shown as an enclosure on a cover letter.
- The audit contact record showed the taxpayer and/or representative was given the required notification of his or her rights.

Most Related Case Files Documented That Taxpayers or Their Representatives Were Advised of Their Rights Regarding Assessment Statute Extensions

⁸ For the 48 tax returns sampled, the Examination function requested 35 extensions and Office of Appeals requested 13.

Improved Documentation Is Needed to Ensure Taxpayers Are Informed of Their Rights When Requested to Extend the Assessment Statute

For the remaining 16 tax returns sampled (33 percent), the related case files did not contain a record that taxpayers had been advised of their rights. For these 16 tax returns, 12 extensions were requested in Examination and 4 were requested in Appeals. As a result, for these taxpayers, we could not determine if the IRS protected the taxpayers' rights to be advised of their statute extension options. This occurred because employees were not following IRS internal guidelines.

However, for 4 of the 16 tax returns, the IRS requested multiple extensions. Although the IRS advised taxpayers of their rights for extension requests at some time during the audit, there was no record in the related case files to verify the taxpayers were notified of their rights for the last extension requests. Though the IRS did not comply with I.R.C. § 6501 for each and every extension, we believe the legislative purpose of the section was fulfilled, i.e., the taxpayers had an understanding of their rights.

I.R.C. § 6501 provides that the IRS must notify the taxpayer of his or her rights on each occasion when the taxpayer is requested to consent to an extension. It would be a potential violation of taxpayers' rights if the IRS did not notify taxpayers of their options when requesting assessment statute extensions. If taxpayers were not notified of their rights, taxpayers might not be aware of their rights to refuse to extend the period of limitations or to limit such extensions to particular items or particular periods of time. This could result in a violation of taxpayer rights.

Employees were not always following IRS internal guidelines

Although 31 of 48 tax returns sampled (65 percent) had some form of documentation of rights in the related case files, not all related case files had complete documentation.

In the Examination-related case files reviewed, 27 of 35 (77 percent) had incomplete documentation. The Examination function manual covering the examination of tax returns requires that when IRS employees request that a taxpayer extend the assessment statute, they provide the taxpayer with an L-907 (maintaining a copy of the letter in

Improved Documentation Is Needed to Ensure Taxpayers Are Informed of Their Rights When Requested to Extend the Assessment Statute

the related case files) and a Publication 1035 as an enclosure. They also must document on a contact record whether the taxpayer was notified of his or her rights.

In the Appeals-related case files reviewed, 4 of 13 (31 percent) had no documentation. In August 2000, Appeals National Headquarters issued an alert providing procedures to ensure documentation is maintained in the related case file to verify rights are provided. However, at the time Appeals requested the extensions, Fiscal Year (FY) 2001, the Appeals manual did not provide procedures requiring documentation of the advice of rights.

The dates to complete corrective actions were postponed

In the FY 2000 review of assessment statute extensions, we recommended the IRS include a requirement that Examination group managers, before approving the statute extension forms, review the related case files for documentation that rights were explained to taxpayers. This corrective action was postponed, and the IRS is in the process of seeking concurrence from the TIGTA to withdraw this FY 2000 action item. Instead, the IRS implemented a corrective action recommended in the TIGTA's FY 2001 report.

In the FY 2001 report, we recommended that the IRS require that assessment statute extension cover letters (L-907 and L-967) confirming advice of rights be attached to statute extension forms when the extension is approved or executed. The cover letter would then be filed together with the extension form directly behind the return to make it easy to locate in the related case file.

Although Small Business/Self Employed Division management issued a memorandum dated February 28, 2002, requiring the attachment of the cover letter to the extension, the action item to incorporate the procedural change into its manual was postponed from January 1 to July 1, 2002. The IRS advised us that the completion of the corrective actions was delayed due to resource limitations. Appeals revised its manual and incorporated the new guidelines on November 30, 2001.

Improved Documentation Is Needed to Ensure Taxpayers Are Informed of Their Rights When Requested to Extend the Assessment Statute

Compliance With Dual Notification Requirements Needs Improvement

IRS management anticipates that no further documentation will be required. Management believes attaching a copy of the cover letter to the taxpayer consent form will provide documentation to the extent that a determination can be made that the taxpayers were advised of their rights. We agree with this approach and are making no recommendations at this time.

In 22 of the 24 (92 percent) jointly filed returns sampled, there was no documentation in the related case files that each taxpayer listed on the return was separately informed of his or her rights (i.e., dual notification). This occurred because employees were not following IRS internal guidelines. However, for all 24 jointly filed returns, at the time of the extension requests, both spouses filing the joint returns resided at the same addresses. For these 22 jointly filed returns, 15 extensions were requested in Examination and 7 were requested in Appeals.

RRA 98 § 3201 requires the IRS to send any notice relating to a jointly filed return separately to each individual filing the joint return. The Congress intended that separate notices would increase the likelihood that separated or divorced spouses receive such notices, as well as increase the likelihood that the IRS will be made aware of address changes that apply to one, but not both, spouses. There could be a violation of taxpayer rights if both taxpayers were not notified of their rights to refuse to extend the period of limitations or to limit such extensions to particular items or particular periods of time.

The Examination manual states that any notice relating to a jointly filed return should be separately mailed to each individual filing the joint return. In addition, Examination management informed us that they would include an article in the IRS Technical Newsletter advising employees of the importance of dual notification requirements.

The Appeals manual does not address dual notification. However, IRS officials issued memoranda on October 28, 1998, and May 13, 1999, that required dual notification for all jointly filed returns. Appeals management informed us that they would revise their manual to include dual notification requirements. We do

Improved Documentation Is Needed to Ensure Taxpayers Are Informed of Their Rights When Requested to Extend the Assessment Statute

Compliance With Procedural Regulations Needs Improvement

not believe the risk warrants additional procedures or reviews and are making no recommendations at this time.

In 24 of the 33 tax returns sampled (73 percent) where taxpayers made a declaration of representation, there was no documentation in the related case files that the IRS had provided both the taxpayers and the representatives with the advice of rights. This occurred because employees were not following IRS internal guidelines. For these 24 tax returns, 16 extensions were requested in Examination and 8 were requested in Appeals.

Current manual guidelines and Federal regulations require that any notice or other written communication (or copy) required or permitted to be given to a taxpayer in any matter before the IRS must also be given to the taxpayer and, unless restricted by the taxpayer, to the taxpayer's representative.

Taxpayer rights or taxpayer burden could be affected if the IRS does not follow the Federal regulations and provide both the taxpayer and the taxpayer's representative with the rights to refuse to extend the period of limitations or to limit such extensions to particular items or particular periods of time.

However, we consider current guidelines appropriate and adequate at this time. Considering the minimal risk, we are making no recommendations at this time.

Management's Response: IRS management responded favorably and agreed with the information included in our report. Specifically, they stated that they are pleased our review found that they are addressing the issues relating to I.R.C. § 6501(c)(4)(B).

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Internal Revenue Service (IRS) is complying with Internal Revenue Code (I.R.C.) Section (§) 6501 requiring the IRS to provide notice to taxpayers of their rights to refuse to extend the assessment statute of limitations or to request that an extension be limited to a specific period of time or to specific audit issues.¹ To accomplish the objective, we did the following:

- I. Determined whether taxpayers were being advised of their rights related to requests to extend the assessment statute of limitations.
 - A. Reviewed the Internal Revenue Manual, IRS memoranda, and IRS Chief Counsel opinions and determined policies and procedures for processing requests to extend the assessment statute of limitations.
 - B. Obtained the Fiscal Year (FY) 2001 (October 1, 2000, to September 30, 2001) Individual Master File² and Business Master File³ databases to identify and review tax returns with adjustments to the assessment statute of limitations within the audit period from October 1, 2000, to September 30, 2001.
 1. Analyzed the databases to identify assessment statute adjustments that could have resulted from extensions by the written consent of taxpayers (assessment statutes are often extended for reasons other than the taxpayer's written consent). For example, all tax returns having a statutory notice of deficiency (90-day letter) have the assessment statute extended for 150 days by law.
 2. Judgmentally selected 48 tax returns to review. We had planned to do a statistical sample of tax returns closed from the Examination and Appeals process. After ordering the tax returns and related case files identified for a statistical sample size, we were unable to receive the documents in sufficient time to do a statistical review. Therefore, we reviewed all tax returns and related case files we had received by June 3, 2002.
 - C. Reviewed the 48 tax returns and related case files to determine if the taxpayers were advised of their rights and if the related case file documentation complied with IRS internal guidelines. In addition, we determined compliance with the IRS

¹ I.R.C. § 6501(c)(4)(B) (Supp. IV 1998).

² The IRS database that maintains transactions or records of individual tax accounts.

³ The IRS database that consists of Federal tax-related transactions and business accounts. These include employment taxes, income taxes on businesses, and excise taxes.

Improved Documentation Is Needed to Ensure Taxpayers Are Informed of Their Rights When Requested to Extend the Assessment Statute

Restructuring and Reform Act of 1998 § 3201⁴ for the 24 jointly filed returns and compliance with Federal regulations⁵ for the 33 tax returns where the taxpayer made a declaration of representation.

- II. Determined if the IRS completed corrective actions in response to the recommendations presented in the Treasury Inspector General for Tax Administration FY 2000 and 2001 reports.⁶
- III. Followed up with IRS officials to discuss those tax returns and related case files where we determined the IRS did not comply with the law, regulations, or internal guidelines.

⁴ Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

⁵ 26 C.F.R. § 601.506 (2001).

⁶ *Information Provided to Taxpayers When Requesting Extensions of the Assessment Statute of Limitations Can Be Improved* (Reference Number 2000-10-142, dated September 2000); *Most Taxpayers Are Advised of Their Rights Before Signing an Agreement to Extend the Assessment Statute of Limitations* (Reference Number 2001-10-157, dated September 2001).

Major Contributors to This Report

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**Improved Documentation Is Needed to Ensure Taxpayers Are Informed of Their Rights
When Requested to Extend the Assessment Statute**

Appendix III

Report Distribution List

Commissioner, Large and Mid-Size Business Division LM
Commissioner, Small Business/Self-Employed Division S
Commissioner, Tax Exempt and Government Entities Division T
Commissioner, Wage and Investment Division W
Chief, Appeals AP
Director, General Appeals Program AP:G
Director, Compliance, Small Business/Self-Employed Division S:C
Director, Exempt Organizations T:EO
Director, Field Assistance, Wage and Investment Division W:CAR:FA
Director, Field Specialists, Large and Mid-Size Business Division LM:FS
Director, Reporting Compliance, Small Business/Self-Employed Division S:C:CS
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Chief, Appeals AP:P:S

Improved Documentation Is Needed to Ensure Taxpayers Are Informed of Their Rights When Requested to Extend the Assessment Statute

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that the review results will have on tax administration. While no recommendations were made in this report, the Treasury Inspector General for Tax Administration (TIGTA) has made prior recommendations that would have affected its Fiscal Year (FY) 2001 review results. However, the Internal Revenue Service (IRS) did not implement the corrective action for the prior year recommendations until after the current year's audit period. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

In 37 of 48 tax returns sampled, the IRS did not comply with:

- Taxpayer Rights and Entitlements – Potential; I.R.C. § 6501(c)(4)(B) (Supp. IV 1998) in 16 of 48 taxpayer accounts affected (see page 3).
- Taxpayer Rights and Entitlements – Potential; IRS Restructuring and Reform Act of 1998 (RRA 98)¹ § 3201 in 22 of 24 jointly filed accounts affected (see page 6).
- Taxpayer Rights and Entitlements – Potential; 26 C.F.R. § 601.506 (2001) in 24 of 33 tax accounts where the taxpayers declared a representative (see page 7).

Methodology Used to Measure the Reported Benefit:

We selected a judgmental sample of 48 tax returns with consents to extend the assessment statute of limitations period. The returns were identified from the FY 2001 Individual Master File² and Business Master File³ databases. The review showed taxpayer rights were potentially affected in 37 of 48 tax returns sampled. Each sampled tax return and related case file could have multiple findings for each criterion. Related case files were not documented in 16 of 48 taxpayer accounts to show the taxpayers or their representatives received their rights to refuse or restrict the scope of the statute extensions. There was no documentation in the related case files that each taxpayer listed on the return (44 taxpayers) was separately informed of his or her rights in 22 of 24 jointly filed accounts. In addition, in 24 of the 33 tax accounts where taxpayers made declarations of representation, there was no documentation in the related case files that the IRS had provided both the taxpayers and the representatives with the advice of rights.

¹ Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

² The IRS database that maintains transactions or records of individual tax accounts.

³ The IRS database that consists of Federal tax-related transactions and business accounts. These include employment taxes, income taxes on businesses, and excise taxes.

**Improved Documentation Is Needed to Ensure Taxpayers Are Informed of Their Rights
When Requested to Extend the Assessment Statute**

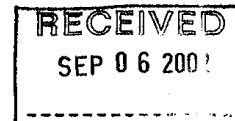
Appendix V

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

SEP 6 2002



MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: *for* Joseph G. Kehoe *Joe G. Kehoe*
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Improved Documentation Is Needed
To Ensure Taxpayers Are Informed of Their Rights When
Requested to Extend the Assessment Statute
(Audit #200240006)

As I reviewed your draft report, I was pleased to see that your review found that we are addressing the issues relating to section 6501(c)(4)(B) of the Internal Revenue Code and made no recommendations.

This section of the Code requires us to notify to taxpayers of their rights to refuse to extend the assessment statute of limitations or to request that we limit any extension to a specific time period or specific audit issues. You must provide information annually on our compliance with this code section. The overall objective of this review was to determine whether we were complying with the requirements of the law.

Your report found:

- Employees properly advised taxpayers of their rights to refuse or restrict the statute extension in 67% of the tax returns surveyed. In 33% of the surveyed cases, you could not determine whether we properly advised taxpayers of their rights because we lacked the documentation. You recommended in your FY 2001 report that we attach the assessment statute extension cover letters, confirming advice of rights, to statute extension forms when the extension is approved or executed. Small Business/Self-Employed (SB/SE) Division management issued a memorandum dated February 28, 2002, explaining this process. We have begun the action item to incorporate the procedural changes into the IRM. The Office of Appeals revised its manual and incorporated the new guidelines on November 30, 2001. You agreed that this approach should resolve the issue of lack of documentation.

Improved Documentation Is Needed to Ensure Taxpayers Are Informed of Their Rights When Requested to Extend the Assessment Statute

2

- Employees had not documented some related case files showing he or she separately informed each taxpayer listed on the return of his or her rights (i.e., dual notification). In 22 of 24 jointly filed cases sampled, you found no documentation in the related case files that an employee had separately informed each taxpayer of his or her rights. For all 24 cases reviewed, at the time of the extension requests, both taxpayers resided at the same addresses. The Examination manual states that employees should separately mail notices on a jointly filed return to each individual filing the joint return. To re-emphasize this point, SB/SE included an article in the *June 2002 Technical Newsletter* telling employees of the importance of the dual notification requirements. Appeals management issued memoranda on October 28, 1998, and May 13, 1999, that required dual notification for all jointly filed returns. Appeals is planning to revise its manual. You agreed with our approach and believe that we need no additional guidance or reviews.
- Employees did not document some cases, where taxpayers made a declaration of representation, that we had explained their rights to both the taxpayers and the representatives. Current manual guidelines and Federal regulations require that employees give both the taxpayer and his or her representative, unless the taxpayer restricts it, any notice or other written communication (or copy) the law requires or permits to be given to a taxpayer in any matter before the IRS. You considered our current guidelines appropriate and adequate at this time.

If you have any questions, please call me at (202) 622-0600 or Joseph Brimacombe, Deputy Director, Compliance Policy, Small Business/Self-Employed Division, at (202) 283-2200.